Loyalty Programs: All Fun and Games Until Someone Wants You to Buy Them a Harrier Jump Jet

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IN-HOUSE COUNSEL SHOULD CONSIDER THE MYRIAD LEGAL ISSUES THAT CAN AFFECT A CONSUMER LOYALTY PROGRAM, INCLUDING NUMEROUS CONSUMER, FRANCHISEE AND REGULATORY ISSUES.

To incentivize repeat customers and to attract new ones, your sales and marketing department devises an ingenious rewards program. Customers will earn points based on their purchases of your product and can redeem the points for different items. To generate consumer buzz, your marketing department wants to create flashy ads showing items for purchase with astronomical point values — a luxury sports car, a new home, even a Harrier Jump Jet! You think the loyalty program is a great idea, but, as in house counsel, you ask, “where are the minefields?” Loyalty and rewards programs create legal vulnerabilities to three classes of potential adversaries: (1) consumers, (2) franchisees, if applicable, and (3) state law enforcement agencies and regulators.
Consumer Issues
While loyalty programs provide incentives for customers to remain loyal, they can also create contractual obligations. Typically, courts analyze loyalty and rewards programs like unilateral contracts: the program sponsor presents an offer of terms and conditions that the consumer(s) can accept by performance. Entering into unilateral contracts with thousands — if not millions — of consumers presents myriad liability issues with the potential for class actions based on contract breach, fraud and unfair competition, among other grounds.

To ensure that your loyalty program generates sales and not litigation, recognize that advertising is the means by which the terms and condition of the offer are made. Courts have excepted reward programs from the general rule that advertisements do not constitute offers. Therefore, you should make sure your company advertises the program consistent with the stated terms and conditions in all advertisements. Just recently, Shell Oil agreed to settle class action consumer fraud claims arising out of its “Ski Free” Program for $2.2 million because its advertisements were allegedly inconsistent with the program’s term and conditions. Shell’s ads promised free ski-lift tickets for buying 10 gallons of Shell gasoline; however, the official terms and conditions offered a free ticket only when the participant purchased a ticket, i.e., “buy-one-get-one-free.” In refusing to dismiss the putative consumer class action based on breach of contract, an Oregon federal court explained that advertisements are generally not understood as offers to sell, but there is an exception for reward offers. The court noted that a consumer could reasonably understand the “Ski Free” promotion to mean that a free lift ticket was the reward for purchasing fuel and not a buy-one-get-one-free promotion.

At the same time, an offer has to be serious to constitute an enforceable contract. In a notorious case, Pepsi advertised a rewards program in which consumers could accumulate points by purchasing Pepsi and exchange the points for certain luxury items. A television commercial included a scene where a teenager arrived at his high school in a Harrier Jump Jet, a fighter aircraft used by the U.S. Marines. The ad’s subtitle showed that the jet cost 7 million rewards points. A high school student and some creative friends tendered enough rewards points to purchase the jet, but Pepsi refused to supply the item, arguing that the jet was not part of the promotion. After protracted litigation, the U.S. Court of Appeals for the Second Circuit affirmed summary judgment for Pepsi, agreeing with the district court’s conclusions that this particular advertisement was not a contract or offer to sell and that no reasonable person could think a serious offer was intended.
For programs that require registration, like frequent flyer programs, it is equally important that you explicitly reserve the right to change or alter program terms and conditions or to cancel the program outright. Courts have frequently upheld provisions in loyalty program terms and conditions that allow the program sponsors to cancel, change or otherwise alter the programs. For example, courts have found in favor of both Delta\(^6\) and United\(^7\) in breach of contract actions where unhappy consumers alleged that frequent flyer program rules were changed improperly. In United’s case, the court noted that the terms of the program permitted United to make unilateral changes to the program rules. The plaintiff in the Delta case similarly could not demonstrate that Delta’s change in how mileage awards were allocated violated the program rules, despite the fact that the rules themselves were ambiguous. Alaska Airlines also won a case in which the court noted that the plain language of the program permitted changes to the program and that it was reasonable for these change to apply retroactively.\(^8\)

**Franchise Issues**

Franchisors should also consider a loyalty program’s impact on their franchise network. Franchisees are crucial to a program’s success because they interact with customers and promote the program. And, just as franchise systems depend on uniform product offerings, a uniform loyalty or rewards program in which all retail outlets participate is essential to its success. Typically, franchisees will participate in programs that generate more business, but they often do not want to pay for the program. The starting point is to assess whether (1) a franchisor can force its franchisees to participate in the loyalty program and (2) whether it can force its franchisees to pay for — or at least contribute to — the costs of the program in the franchise agreement. Questions include:

- What protection does the franchise agreement afford the franchisee?
- Can franchisors require franchisees to participate in franchisor-sponsored loyalty programs, and who bears the cost of the program?
- Does the agreement allow the franchisor to impose system changes on franchisees, and, if so, are there any restrictions on the type and scope of the changes allowed?
- Does the agreement provide indemnification to the franchisee for any litigation arising out of the franchisor-sponsored loyalty program?
Franchisors should explicitly reserve the right to change the terms and conditions of loyalty programs as they apply to franchisees. A provision in the franchise agreement that generally permits the franchisor to make changes to “systems standards” or “rules of operation” may not be sufficient to allow franchisors to change the terms and conditions of loyalty programs or unilaterally increase program fees.\(^9\) At the same time, franchisors do have the ability to force a franchisee to engage in a system-wide program if the franchise agreement specifically permits the franchisor to do so. Recently, a federal judge in Colorado granted summary judgment to a franchisor against a franchisee which refused to participate in a “4 Meals Under $4 Menu” promotion. \textit{Steak N Shake Enters v. Globex Co., LLC}, 110 F. Supp. 3d 1057 (D. Colo. 2015). The franchisee had even gone so far as to print its own menu inserts with improper pricing. In its franchise agreement, Steak N Shake required franchisees to “fully participate in all local, regional, season, promotional and other programs, initiatives and campaigns adopted by Franchisor that Franchisor requires Franchisee to participate in.” The agreement also prohibited franchisees from printing menus without the franchisor’s approval. The Court found that the franchisee materially breached the agreements, noting that the franchise agreements made explicitly clear what the franchisee requirements were.

Some jurisdictions, like the District of Columbia,\(^{10}\) outright prohibit franchisors from requiring franchisees to participate in loyalty programs in certain industries. In these jurisdictions, franchisee participation in any loyalty program must be entirely voluntary, and franchisees who elect not to participate cannot be punished or penalized for choosing not to participate. Program sponsors may consider providing incentives for franchisees to participate in loyalty programs.

Setting aside the obvious legal issues discussed above, franchisors must also be aware of how the franchisee implements the program to reduce any litigation exposure. As discussed above, advertising the program consistent with its official terms and conditions is essential. Likewise, franchisors must be able to control and monitor a franchisee’s advertisement of any loyalty program through effective oversight and supervision. Additionally, program administrators should ensure that franchisees are satisfied with the loyalty or rewards programs.\(^{11}\) Frequent communications with franchisees about loyalty programs can ensure a smooth program implementation and that both customers and franchisees are satisfied.
Regulatory Issues: State Legal Regimes

In addition to the various contractual pitfalls presented by loyalty programs, there are regulatory regimes in some states that can also impact these programs, especially rewards programs that provide incentive cash rewards, which may affect a marketer’s final sales price. Program sponsors need to consider how the cash rewards may affect compliance with competition laws, such as below-cost-sales statutes, which exist in a number of states.

Depending on the industry, state law may even prohibit the implementation of any loyalty program whatsoever. In New Jersey, for example, petroleum marketers cannot run loyalty discount programs, although there is an exception for programs run through credit card companies. Other states, such as Florida, require “trading stamps,” which include discount coupons issued in connection with the retail sales of merchandise or services, to have a cash value legibly printed on their face. Still other states require sweepstakes operators offering more than a certain amount in prizes to register with the state, post a bond and comply with certain other promotional and operational requirements.

Before developing and rolling out a loyalty program, you should be sure to check the relevant state laws and regulatory regimes. Local laws may affect the overall structure of the loyalty program and/or may mean that programs will have to differ from state to state.

Practice Tips

In-house counsel should consider the myriad legal issues that can derail an otherwise-successful program before implementing a consumer loyalty program, including numerous consumer, franchisee, and regulatory issues. In order to ensure your programs are best-insulated from liability, you should remember the following tips:

- Ensure program advertisements are consistent with the program’s terms and conditions and are not too overreaching or hyperbolic — don’t advertise jump jets for sale if they are not for sale.

- Reserve the right to alter the terms and conditions of the loyalty program, including reserving the right to apply changes retroactively to benefits already accrued under the program.

- Make sure franchise agreements require franchisees to participate in the program, and confirm that state law allows you to enforce the requirement. The franchise
agreement must expressly permit you to change the terms of the program once implemented.

- Check state-specific laws for the states in which you want to operate the program. Each state has its own regulatory regime that may significantly affect the operation of loyalty programs.

Endnotes

1. This is based on the real life case of Leonard v. PepsiCo, Inc. discussed below.


10. See D.C. Code § 36-303.01 (discussing nonwaiverable conditions of marketing agreements for retail service stations).
11. McDonald’s is currently facing problems with its franchisees’ implementing the new all-day breakfast menu. Franchisees complain that all-day breakfast slows down service, reduces the price of the average meal sold and causes “chaos” in the kitchen due to the extra labor required. While customers may love the all-day breakfast, franchisees do not. “McDonald’s franchisees say all day breakfast is a nightmare,” Business Insider (Oct. 15, 2015), available at http://www.businessinsider.com/mcdonalds-franchisees-say-all-day-breakfast-is-a-nightmare-2015-10.


13. See Fla. Stat. § 559.03.

14. Sweepstakes are heavily regulated by state law, as sweepstakes have been a way that scammers have targeted customers in the past. For an overview of sweepstakes law, see, e.g., 3-55 The Law of Advertising § 55.09: Lotteries, Games of Chance, Sweepstakes, and Similar Promotional Marketing Schemes (2015); “Regulating the Sweepstakes Industry: Are Consumers Close to Winning?, ” 41 Santa Clara L. Rev. 581 (2001).